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November 1988 Monthly Survey December 2, 1988

Surveys of Consumers

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Confidence Dims But Remains At Favorable Level

Index Slips

The Index of Consumer Sentiment was 93.0 in the November 1988 survey, down slightly from 94.1 in October. Although this was the second small monthly decline from the 97.3 recorded in September, it remained substantially above the post crash low of 83.1 recorded in November 1987. Overall, the November reading was only marginally below the average recorded during 1988 (93.9) and the average reading during the past five years (94.0).

The recent declines were due to less favorable assessments by consumers of their current financial situation, although they still remained upbeat about financial prospect for the year ahead.

Among families with incomes of $40,000 or more, the Index slipped to 101.0 in November 1988 from 103.7 in October, and 105.4 in September. Like the all families figure, the November Index among high income families was substantially above the year earlier figure of 90.5.

Personal Finances Weaken

Consumer's assessments of their current financial situation have weakened from the record levels recorded earlier in 1988. Among all families in the November 1988 survey, 41 percent reported that their financial situation improved during the past year, confirming the decline recorded in October. Although the current reading is substantially below the 50 percent recorded in August 1988, it is comparable to the year earlier reading. Moreover, the 50 percent figure represented the highest proportion recorded in more than twenty years. That current evaluations have declined from that peak is not very surprising given past trends in personal incomes.

Compared with three months earlier, fewer families reported gains in incomes (35, down from 45 percent), while the proportion reporting income declines remained unchanged (at 16 percent).

Despite the muted evaluations of their current financial situation, consumers continued to hold positive prospects for the year ahead. Among all families in the November 1988 survey, 37 percent expected their financial situation to improve during the year ahead, just ahead of the 36 percent recorded one month earlier and the 33 percent recorded one year earlier. Just 9 percent of all families in the November survey expected their financial situation to worsen, down from 12 percent one month earlier and 15 percent one year earlier.

Inflation Remains Troublesome

In the November 1988 survey, consumers expected the annual inflation rate to average 5.4% during the year ahead. This represents a largely unchanged outlook since inflation expectations rose sharply in the Spring, reaching 5.6% in June. Although this

does indicate that these fears have not escalated during the past six months, they have not eased significantly either. Importantly, they remain substantially above the 3.9% recorded last November, and at the highest sustained level recorded since the current expansion began.

Outlook for National Economy Holds Steady

In contrast to the weakened evaluations of their current financial situation, more consumers thought that current business conditions in the country as a whole had improved over those of a year earlier. Among all families, 54 percent thought that the economy had improved, up from 46 percent one month earlier, and the highest proportion recorded in more than a year.

When asked about prospects for the economy during the year ahead, three times as many families in the November survey expected the performance of the economy to remain unchanged (60 percent) than to either improve (19 percent) or worsen (18 percent).

The widespread expectation of an unchanged outlook for the economy has meant the continuation of good times financially for the majority of consumers. Among all families in the November 1988 survey, 53 percent expected good times financially in the country as a whole, a reading that has remained largely unchanged during the past three months.

Unemployment Expectations Remain Favorable

For the consumer, favorable employment prospects represent the primary source of the current strength in the national economy. In the November 1988 survey, the majority of families (57 percent) expected the national unemployment rate to remain largely unchanged at its current low level during the year ahead. To be sure, as the expansion has lengthened and the unemployment rate has fallen, fewer and fewer consumers expected further declines, and more consumers expected renewed increases. Although more consumer expected increases rather than declines in the national unemployment rate in the November 1988 survey, the margin of difference has narrowed over the past two years.

Expected Interest Rate Increases Primary Concern

Interest rates were expected to increase by 62 percent of all families in the November 1988 survey. Although this reading is unchanged from October, it represents a small improvement from the recent peak of 71 percent recorded in August. Overall, these very unfavorable interest rate expectations are the single most troublesome aspect of future economic prospects. These concerns over rising interest rates have dulled buying attitudes.

Buying Attitudes Remain Favorable

Attitudes toward buying conditions for appliances, furniture, home electronics, vehicles, and homes have all remained at very favorable levels in the November 1988 survey. To be sure, in each case these buying attitudes have receded from the cyclical peaks recorded earlier in the expansion, but they nonetheless remain at quite favorable levels.

Favorable attitudes toward buying conditions for appliances, furniture and home electronic goods were held by 73 percent of all families in the November 1988. This reading was unchanged from the October survey. Although this was the highest November reading since the current economic expansion started, it is somewhat below the mid 1988 peak of 79 percent.

These very favorable attitudes toward buying conditions for household durables continued to be based on the availability of reduced and

discounted prices. In the November 1988 survey, one-third of all consumers held favorable perceptions of current market prices, three times the number that complained about high prices for these goods.

Favorable attitudes toward buying conditions for vehicles were held by 61 percent of all families in the November 1988 survey. This figure has remained largely unchanged during the past six months, staying in the narrow range of from 60 to 62 percent. When asked to explain their views, favorable perceptions of vehicle prices continue to dominate their answers, although by a smaller margin than in past surveys. Among all families, 27 percent mentioned the availability of discounted prices, down from 31 percent in October; offsetting this rise, however, fewer consumers complained about high prices in the November survey--17, down from 19 percent in October.

Although vehicle buying attitudes remain quite favorable, they are well below the cyclical peak reached two year ago. The primary reason for the softening of these attitudes has been less favorable views of current interest rates on vehicle purchases.

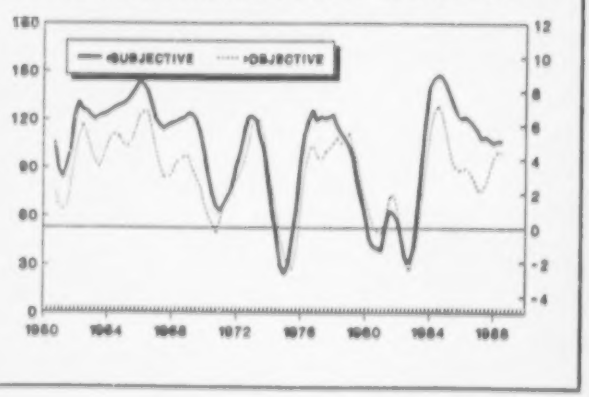
In the November 1988 survey, attitudes toward buying conditions for homes regained some of the loss recorded in October. Among all families, 67 percent reported favorable views toward home buying conditions, up from 64 percent in October, but still below the 70 percent recorded in September. The recent changes in these attitudes has been due to changing perceptions of future trends in mortgage rates. During the past few months the appeal of borrowing-in-advance of rising interest rates has fallen, from 22 percent in September to 13 percent in November, while reports of the availability of currently low mortgage rates rose, from 22 percent in September to 33 percent in November. Even with this improvement, favorable perceptions of mortgage interest rates remained well below the levels recorded during the past few years.

The Sophisticated Consumer

How accurate are consumer expectations? It has been suggested that the very favorable levels of consumer sentiment recorded during the past few years have exceeded the strength of the underlying economic factors. To address this issue, this report includes data that compares the consumer's subjective and qualitative assessments of economic conditions with the objective and quantitative measures derived from the National Income and Product Accounts. As we shall see, there indeed has been some unwarranted persistence of favorable assessments, but for the most part consumer attitudes and expectations have closely mirrored objective measures. Of course, for many pundits it will come as a surprise that consumer attitudes and expectations could demonstrate any coherent relationship with the prevailing macro economic conditions.

National Economy. Consumers are asked in each survey to assess the progress made by the national economy during the past year. When these subjective assessments of the national economy are compared with actual changes in the Gross National Product, a remarkably close correspondence emerges. Chart A shows the four

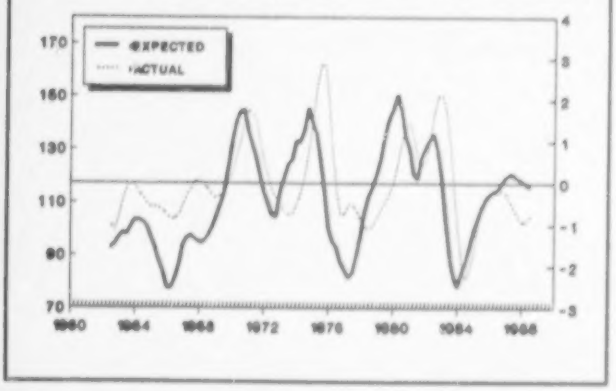
CHART A
ASSESSMENTS OF BUSINESS CONDITIONS
AND PERCENTAGE CHANGE IN REAL GNP



quarter moving average of the annual percentage changes in real GNP and the four quarter moving average of the consumers assessments of change in the economy. The time series correlation of the two series from 1960 to present was 0.90. These data indicate that these subjective assessments are in line with the historical pattern, although they do show a small divergence during the current expansion. For the period from 1972 through 1984, the time series correlation was 0.92, which falls only modestly to 0.89 when the time period is extended through the third quarter of 1988.

Unemployment Rate. The expected change in the national unemployment rate is compared with actual changes in Chart B. Since consumer are asked about the direction of expected change in the unemployment rate, not its level, the annual percentage point change in the national unemployment rate was used as the objective measure. Both consumers' expectations and the percentage point change in the unemployment rate are shown as four quarter moving averages.

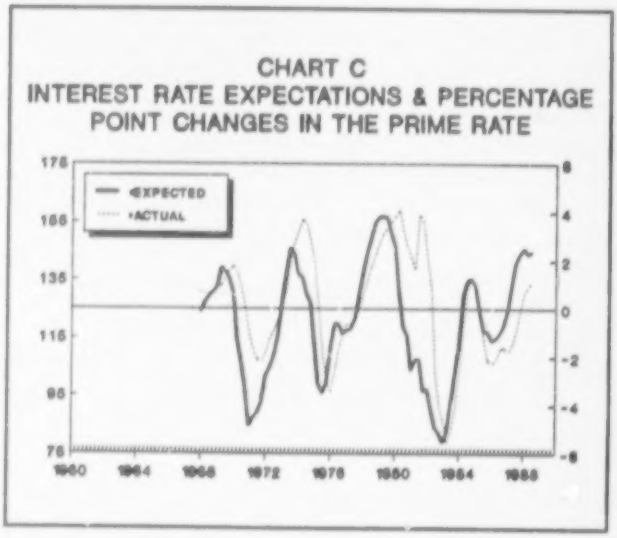
CHART B
UNEMPLOYMENT EXPECTATIONS & PERCENTAGE POINT CHANGE IN THE UNEMPLOYMENT RATE



As can be seen from the chart, the unemployment expectations series foreshadows actual changes in the unemployment rate to a high degree. Consumer expectations changed three quarters in advance of the actual change in the unemployment rate, demonstrating a time series correlation of 0.78 with this lead. Moreover, there has been little change in this relationship during the current expansion.

Interest Rates. To assess the accuracy of the interest rate expectations series, the annual percentage point change in the prime rate was used so as to be consistent with the survey question, which focuses only on the direction of the expected change. Again, both series are shown as four quarter moving averages. The pattern of changes in the subjective expectations and the subsequent changes in the prime rate are shown in Chart C. As shown there, consumer expectations changed, on average, two quarters in advance of the change in the prime rate, achieving a time series correlation of 0.78 with that two quarter lead.

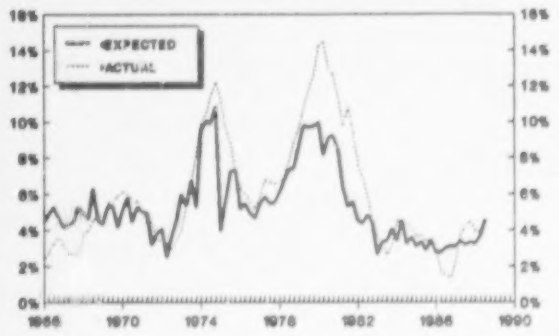
CHART C
INTEREST RATE EXPECTATIONS & PERCENTAGE POINT CHANGES IN THE PRIME RATE



Inflation Rate. The change consumers expect in the annual inflation rate and the actual annual rate of change in the CPI-u is shown in Chart D. For the expectations series, the median expected price increase was used--which yields lower estimates of expected inflation than the mean of the same series. As can be seen from this chart, the peak inflation rates in past years have been underestimated, but during the current expansion

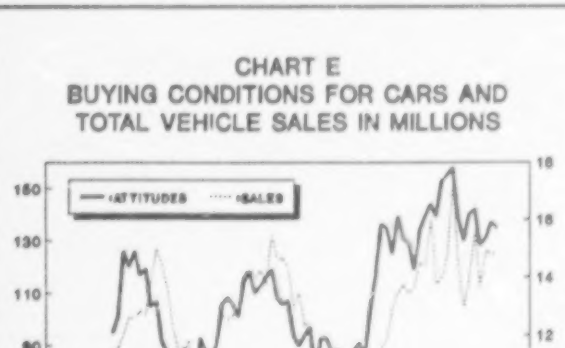
the relationship has been quite close. Changes in price expectations, on average, preceded changes in the CPI by one quarter. From 1966 to present, a time series correlation of 0.90 was achieved when the expectations series was led one quarter.

CHART D
MEDIAN PRICE EXPECTATIONS AND
CHANGE IN CONSUMER PRICE INDEX



Vehicle Sales. Chart E shows the correspondence of vehicle buying attitudes with sales of new cars and light trucks in million of units at annual rates.

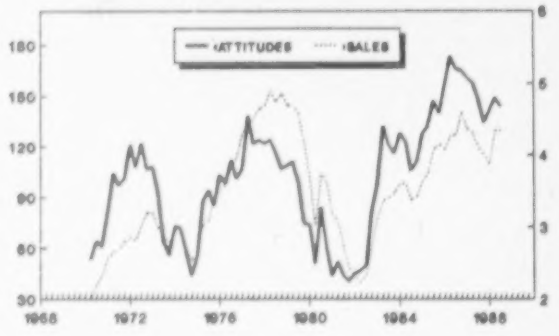
CHART E
BUYING CONDITIONS FOR CARS AND
TOTAL VEHICLE SALES IN MILLIONS



On average, changes in buying attitudes preceded changes in sales by two quarters. A time series correlation of 0.75 was achieved when the attitude series was led two quarters, although it was nearly as high with a lead of up to four quarters.

Home Sales. Trends in home buying attitudes and sales of new and existing singly family homes in millions of units at annual rates are shown in Chart F. Changes in home buying attitudes preceded changes in sales on average by two quarters. A time series correlation of 0.75 was found when the attitude series was led by two quarters.

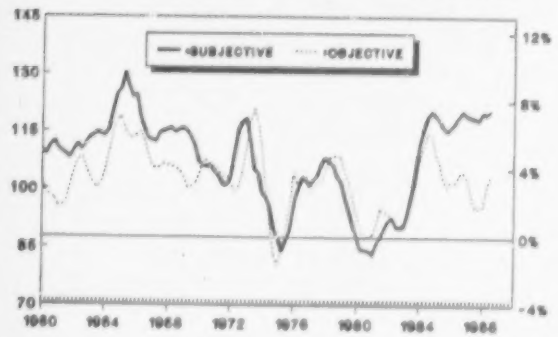
CHART F
HOME BUYING ATTITUDES AND SALES OF
SINGLE FAMILY HOMES IN MILLIONS



Personal Finances. How do consumers' subjective assessments of their current personal financial situation compare with the actual changes in their incomes? Chart G shows the trends in real personal disposable income and consumer assessments. For the series on real personal disposable income, the four quarter moving average of the annual percentage change was used; the attitude series is also shown as a four quarter moving average. The correspondence between the subjective and objective measures has been quite close in the past, but during the current expansion they have shown an uncharacteristic divergence. The simple time series correlation between the two series from 1960 to present was

0.70. For the more recent period from 1972 through 1984, the correlation was 0.88; when this time period is extended to include up to the third quarter of 1988 the correlation falls to 0.66. While measured real income change has slowed considerably as the expansion has lengthened, subjective assessments have remained at high levels. Not surprisingly, in the October and November 1988 surveys, much of the weakness recorded was concentrated in these personal financial evaluations.

CHART G
PERSONAL FINANCIAL ASSESSMENTS AND CHANGE IN REAL DISPOSABLE INCOME



While it can be expected, based on these past trends, that the recent divergence will eventually narrow, the closing of this gap may depend more on trends in inflation than nominal incomes. Although at present consumers continue to favorably view income and employment prospects for the year ahead, rising inflation rates could quickly erode these positive attitudes, especially since these favorable assessments have outdistanced actual developments in incomes. Indeed, one of the interesting results from the comparisons between consumers' subjective assessments and actual economic changes is that the largest gap in the otherwise close correspondence was for assessments of personal finances.

Most observers would suggest that since consumers possess more information about their own financial situation than any other aspect of the economy these assessments would provide a more accurate reflection of actual conditions. Given the results on the inflation expectations comparisons, the answer does not lie in consumers' underestimation of inflation; that consumers overestimated the growth in their nominal incomes, although unlikely, cannot be rejected however.

Perhaps a more plausible explanation is that it has been the relatively stability of inflation that has enhanced consumers' assessments of their economic situation. The uncertainty caused by the inflation of the 1970s led to a pervasive sense of economic insecurity and an inability to plan ahead. The lower and more stable inflation rates that have prevailed since then have given consumers a new sense of confidence in their ability to make financial plans and to provide for future financial needs. It is this renewed sense of financial stability that has made this gap between subjective assessments and actual developments persist. And it is a resurgence in inflation that could cause this gap to quickly close.

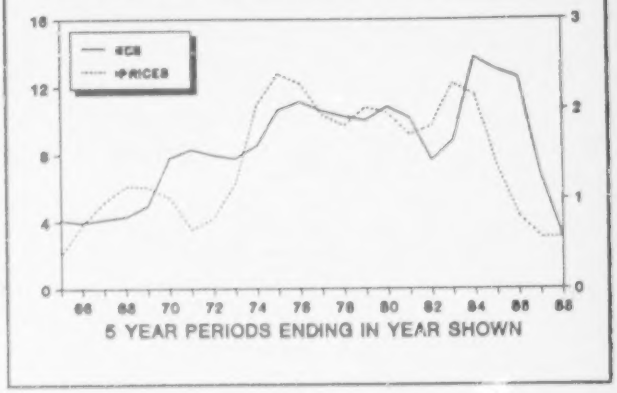
Even if nominal income growth rates accelerated along with rising inflation, thus offsetting its impact on real incomes, the rising inflation would result in a declining sense of financial well-being. For consumers, the same rate of growth in real income is always preferred when accompanied by lower rather than higher rates of change in nominal incomes and prices.

This preference does not mean that consumers suffer from money illusion, but that consumers place a premium on economic stability. Indeed, consumers may well prefer somewhat lower real income growth rates if accompanied by a low rate of inflation. While this preference has often characterized consumers in other countries, for the U.S. consumer it has been the experiences of the past decade that has made it a more compelling preference.

Following the troubled and turbulent 1970s, the

1980s will certainly be remembered for the renewed economic stability. During the past five years the quarterly movements in the Index of Consumer Sentiment as well as price expectations have exhibited the lowest standard deviations recorded in more than twenty years. Chart H displays the standard deviations of the Index and price expectations for five year periods ending in the year plotted. The chart also indicates that the decline in the variance of Index of Consumer Sentiment was preceded by the decline in the variance of price expectations.

CHART H
STANDARD DEVIATION OF ICS AND PRICE EXPECTATIONS WITHIN 5 YEAR PERIODS



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The November 1988 survey included 508 completed interviews, conducted between November 1 and November 23, 1988.